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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1940

No. 985

H. A. PHILLIPS, TRUSTEE OF THE SOUTHERN BREWING COMPANY, BANKRUPT,

Petitioner,

vs.

A. M. ARNOLD.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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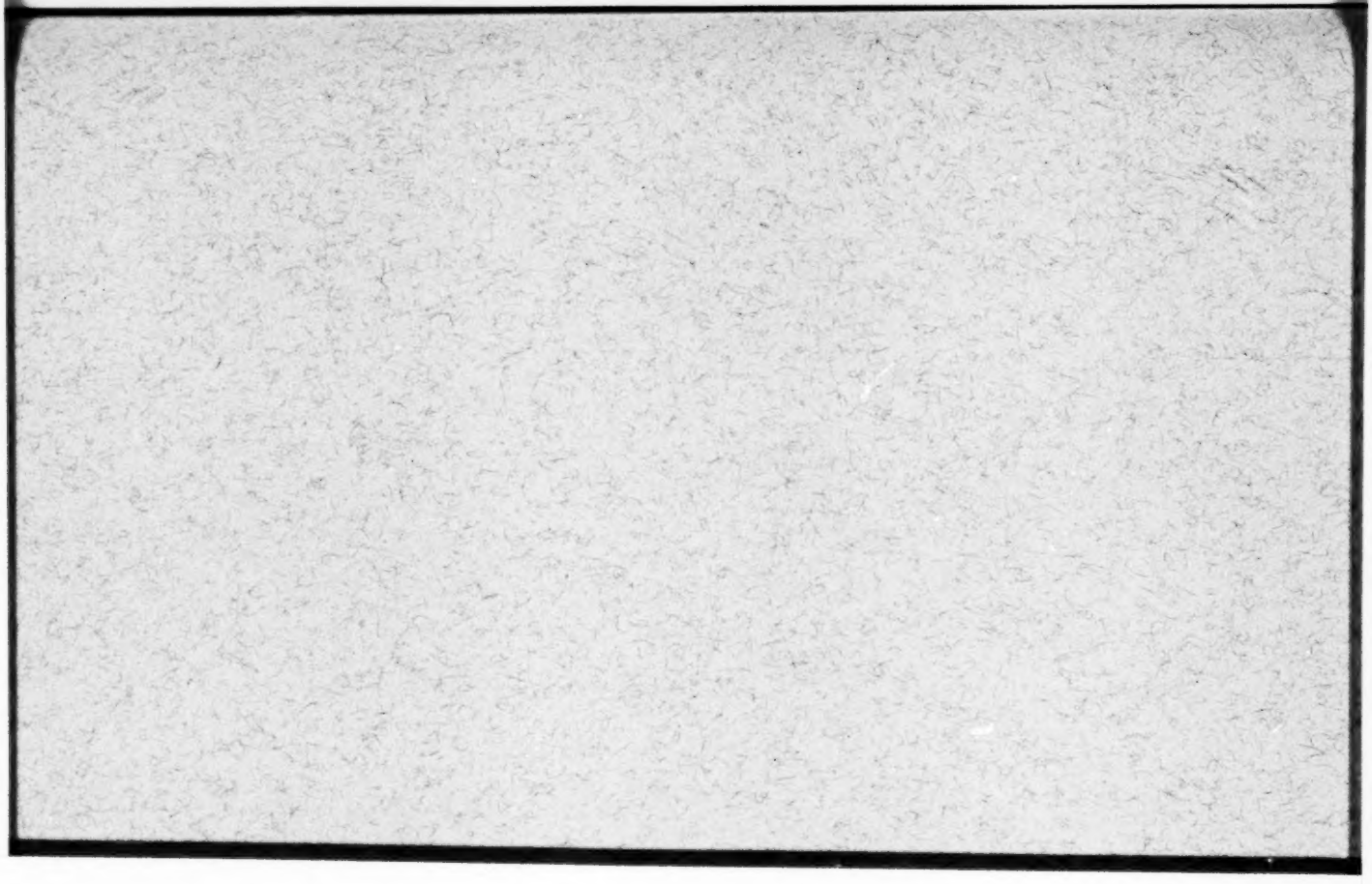

INDEX.

Subject Index.

	Page
Petition for writ of certiorari	1
Summary statement of the matter involved	2
Opinions below	3
Jurisdictional statement	3
Questions presented	3
Reasons relied on for the allowance of the writ	4
Brief in support of petition	5
Specifications of error	8
Brief of argument	9
Summary of argument	9
Argument	10
Conclusion	17

Table of Cases Cited.

Aransas Pass Harbor Co. v. *Manning*, 94 Tex. 558	14, 15, 17
Austin City Ry. Co. v. *Swisher*, 1 White & Willson Civil Cases, 33	16
Boston & Texas Corp. v. *Guarantee Life Insurance Co.*, 233 S. W. 1022	14
Burntside Lodge, Inc., In re, 7 Fed. Supp. 785	10
Bush v. *Gaffney*, 84 S. W. (2d) 759	14
Centmont Corporation v. *Marsch*, 68 F. (2d) 460	5, 10
Charles K. Horton, Inc., In re, 22 Fed. Supp. 905	10
City of Floydada v. *Gilliam*, 111 S. W. (2d) 761	16
Clere Clothing Co. v. *Union Trust & Savings Bank*, 224 Fed. 363	5, 10
Consolidated Rock Products Co. v. *DuBois*, — U. S. — (No. 400, October Term, 1940, decided March 3, 1941)	12
Continental Supply Co. v. *Forrest E. Gilmore Co.*, 55 S. W. (2d) 622	14
Forbush Co. v. *Bartley*, 78 F. (2d) 805	10
Henry v. *Dolley*, 99 F. (2d) 94	5, 10
Irish v. *Bahner*, 109 S. W. (2d) 1023	14
Kentucky Wagon Mfg. Co., In re, 71 F. (2d) 802	5, 10

Page

Lybrand v. *Miller-Lybrand Co.*, 75 S. W. (2d) 286 ... 14
New York Trust Co. v. *Island Oil & Transport Corporation*, 56 F. (2d) 580 ... 5, 10
Nicholstone City Co. v. *Smalley*, 51 S. W. 527 ... 5, 16
Otsego Waxed Paper Co., In re, 14 Fed. Supp. 15 ... 10
Pepper v. *Litton*, 308 U. S. 295 ... 4
Taylor v. *Standard Gas & Electric Co.*, 306 U. S. 707 ... 4, 11
Tenison v. *Patton*, 95 Tex. 284 ... 5
Texas Auto Company v. *Arbetter*, 1 S. W. (2d) 334 ... 5
United States & Mexican Trust Co. v. *Delaware Construction Co.*, 112 S. W. 447 ... 15
Wichita Falls Electric Co. v. *Huey*, 246 S. W. 692 ... 16
Williams v. *Freeport Sulphur Co.*, 40 S. W. (2d) 817 ... 14

STATUTES CITED.

Bankruptcy Act of 1938, Sec. 24(c) (U. S. Co., Title 11, Sec. 47(c)) ... 3
Judicial Code, Sec. 240, as amended (U. S. C., Title 28, Sec. 347) ... 3

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vs.

A. M. ARNOLD.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

MAY IT PLEASE THE COURT:

H. A. Phillips, Trustee of the Southern Brewing Company, Bankrupt, respectfully prays that a writ of certiorari issue to review the final judgment rendered in this cause February 4, 1941, by the United States Circuit Court of Appeals for the Fifth Circuit in which the Circuit Court of Appeals reversed the judgment of the United States District Court for the Southern District of Texas.

I.

Summary Statement of the Matter Involved.

Respondent A. M. Arnold organized, and during most of its existence was the beneficial owner of all the stock of, the bankrupt, Southern Brewing Company, a Texas corporation. After its adjudication as a bankrupt its creditors discovered that substantially all the tangible property which had been used by it in the operation of its business of brewing and selling beer was being claimed by Arnold under a foreclosure, held about five months prior to the adjudication, of a deed of trust which he, as president of bankrupt, had, some years before, executed to secure himself, as its creditor.

Petitioner, as trustee of the estate, filed a petition before the Referee in Bankruptcy seeking to have declared null and void, the foreclosure, the deed of trust, and the claimed indebtedness, which as of the date of foreclosure amounted to $99,379 (R. 3-6). The principal basis for attack was that bankrupt was but an agency or instrumentality of Arnold; that it had not been treated by him as a separate entity; that the advances made by him to it should, therefore, not be considered as debts entitling him to participate in the assets, on a parity even, with other creditors, and that the deed of trust and trustee's deed, having been executed in an attempt to obtain priority, were illegal and void (R. 11-13).

Petitioner further charged that even if bankrupt should be considered a separate entity, so that Arnold could occupy the status of creditor, the deed of trust and trustee's deed were still invalid, the former for want of proper corporate action to authorize its execution and the latter because it was not recorded prior to bankruptcy (R. 13, 14).

After an extended hearing the Referee held Arnold's claimed indebtedness, as well as the deed of trust and trus-

tee's deed, "wholly void and of no force and effect" and that petitioner as trustee was "the owner of, and holder of the full legal title to" the property in question free and clear of any claim of Arnold (R. 277). The District Judge affirmed the order of the Referee (R. 82). The Circuit Court of Appeals held that the foreclosure was properly set aside and that $52,329 of the claimed indebtedness constituted capital contributions and not loans, but that the remaining $47,050 was a valid debt secured by the deed of trust.

II.

Opinions Below.

Findings of fact and conclusions of law were filed by the Referee on March 7, 1940 (R. 45). The District Judge filed a memorandum opinion June 24, 1940 (R. 78). The opinion of the Circuit Court of Appeals was filed February 4, 1941 (R. 280), and is reported at 117 F. (2d) 497.

III.

Jurisdictional Statement.

Jurisdiction of this cause is conferred upon this Honorable Court by Sec. 240 of the Judicial Code, as amended; United States Code, Title 28, Sec. 347, and by Sec. 24 (c) of the Bankruptcy Act of 1938; United States Code, Title 11, Sec. 47 (c).

IV.

Questions Presented.

1. Whether the sole, dominating stockholder of a corporation, who has organized and operated it as his adjunct or instrumentality, may also be its creditor.

2. Whether the sole stockholder of a corporation, which was operated merely as his corporate pocket, may so manipulate its affairs that when it becomes a bankrupt he

will have priority over its creditors in the satisfaction of his claims against it.

3. Where the sole stockholder of a corporation, who organized it with insufficient capital, intending to advance, under the guise of loans, the funds necessary for its operations, made advances to it shortly after incorporation, a part of which were subsequently withdrawn, after which he made additional advances, is there any sound distinction between the two sets of advances, so that while those made immediately after incorporation are construed as capital contributions, those made subsequently constitute valid loans?

4. Whether a deed of trust executed by the president of a corporation to secure an alleged indebtedness owed him by the corporation, without any authorization of its execution by the board of directors, all of whom had an interest in the transaction adverse to the corporation, constitutes a valid corporate act.

V.

Reasons Relied On for the Allowance of the Writ.

1. The Circuit Court of Appeals, in holding that the sole stockholder of a corporation, which he has used as a mere corporate pocket, may be a secured creditor of his corporate agency or instrumentality, has decided an important question of bankruptcy law in a way in conflict with applicable decisions of this Court. *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307; *Pepper* v. *Litton*, 308 U. S. 295.

2. The Circuit Court of Appeals, in holding that the sole stockholder and real owner of the business of a corporation, which has been organized and operated merely as his agency or instrumentality, may be a creditor of that corporation secured by a lien on all its assets, has rendered a decision

in conflict with the decisions of other Circuit Courts of Appeals on the same matter. *In re Kentucky Wagon Manufacturing Co.*, 6th Cir., 71 F. (2d) 802; *Centmont Corporation* v. *Marsch*, 1st Cir., 68 F. (2d) 460; *Henry* v. *Dolley*, 10th Cir., 99 F. (2d) 94; *Clere Clothing Co.* v. *Union Trust & Savings Bank*, 9th Cir., 224 Fed. 363; *New York Trust Co.* v. *Island Oil & Transport Corporation*, 2nd Cir., 56 F. (2d) 580.

3. In failing to hold that a deed of trust on corporate property, executed, without proper authorization of qualified directors, by the president of a Texas corporation, to secure advances made by him to his Company, is invalid, the Circuit Court of Appeals has decided an important question of local law in a way in conflict with applicable local decisions. *Tenison* v. *Patton*, 95 Tex. 284; *Texas Auto Company* v. *Arbetter* (Tex. Civ. App.), 1 S. W. (2d) 334; *Nicholstone City Co.* v. *Smalley* (Tex. Civ. App.), 51 S. W. 527.

VI.

SUPPORTING BRIEF.

Statement of the Case.[1]

The findings of fact made by the Referee were adopted by the District Judge and were not attacked by respondent. They establish that bankrupt was incorporated on July 12, 1933, with a nominal capital of $50,000, to serve as the agency or instrumentality through which respondent planned to engage in the brewing business (R. 50). He contributed the entire nominal capital and all the stock was issued to him except qualifying shares to his son-in-law, Otto, and an employee, Souza (R. 50, 51). At the time when the corporation was organized, respondent realized

[1] This statement is intended to be read with the summary statement of the petition, supra, pages 1-2.

the nominal capital was wholly insufficient and he planned to, and did, advance, for the construction and equipment of the brewery, additional sums totaling $70,500 (R. 51, 52). He made no attempt, at the time of these advances, to secure himself for them, but in September, 1934, without any authorization by the board of directors, he executed to his daughter, as trustee, a deed of trust covering all the real property of the bankrupt (R. 53). This deed of trust recited that it was to secure a note in the amount of $79,729 [2] and future advances. In 1937 and the early part of 1938 he made additional advances totaling $47,050 (R. 55, 56).

Detailed findings made by the Referee with reference to the manner in which the business of bankrupt was conducted show almost complete disregard of, broken only by occasional lip service to, the conventional methods of conducting a corporate business, and that bankrupt was used as nothing more than a corporate pocket of Arnold, who with disregard for the substance and form of corporate management treated its affairs as his own (R. 52-65). The effect of these findings is summarized in the Referee's certificate as follows:

> "In short, I think and find, that at the times when the advances in question were made the bankrupt was simply the agency or instrumentality of Arnold for carrying on the brewery business, and that the business of the bankrupt, though conducted through the form of a corporation, was in truth and in fact the personal business of A. M. Arnold." (R. 60.)

The evidence showed and the Referee found various abuses in the handling of the affairs of bankrupt of the sort which are, unfortunately, not infrequently associated with

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[2] The $79,729 was made up of the original $70,500, interest on that sum to June 30, 1934, amounting to $4,229, and an additional advance made in June, 1934, of $5,000 (R. 52).

one man ownership and domination of corporations. For example, during a period when the business seemed about to prosper, under the guise, in part, of interest and principal payments on the $70,500 advance, which had been necessitated by the inadequate capitalization, and, in part, of unauthorized salary payments, Arnold withdrew from its funds more than $90,000.[3] In addition to these direct withdrawals he organized another company known as Monte Carlo Distributing Corporation, with a paid-in capital of $1,000, all of whose stock was held by or for him, which handled about 80% of the output of the brewery, with the result that as of the date of bankruptcy it was indebted to bankrupt in an amount in excess of $85,000, which it had no assets to pay (R. 63-65).

As a result of these various manipulations, by the spring of 1938 the affairs of the Brewery were beginning to become seriously involved (R. 65). At this very time, peculiarly enough, respondent purported to transfer the business to his son-in-law, Otto. No consideration was paid for this transfer and the parties testified it was intended as a gift (R. 60). Even if *bona fide*, the transfer is unimportant, because all the advances involved were made before it (R. 55, 56). Significant, however, of the disregard by respondent, himself, of the corporate entity of bankrupt is the fact that after, as well as before, the purported transfer, though he no longer had any official connection with the corporation he continued to dominate and control its affairs (R. 60-61).

The condition of these affairs did not improve during the summer of 1938, and in the fall, respondent, being of the opinion that the failure of the enterprise was imminent,

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[3] He withdrew $19,000 at various times as "interest", $27,400 in the summer of 1936 as "principal payments" on the $79,729 note, and $45,000 as "salary"; none of these withdrawals being authorized by any corporate action (R. 55, 61, 62).

instructed his attorney to foreclose under the deed of trust (R. 65, 66). Pursuant to these instructions, a trustee's sale, at which Arnold was the only bidder, was held November 1, 1938, as a result of which his daughter executed to him a deed conveying the entire brewery premises, plant, and equipment, for a recited consideration of $99,379 (R. 66). This was the total amount in which, as a result of the various advances and withdrawals, he claimed bankrupt was indebted to him at that time (R. 66). This trustee's deed was not recorded until April 24, 1939, twelve days after the adjudication of bankruptcy, and during the intervening time bankrupt continued to occupy the property and operate the brewery business thereon exactly as it had before (R. 66-68).

Specifications of Error.

I.

The Circuit Court of Appeals erred in holding that Arnold, the real owner of the business of bankrupt, could at the same time be its creditor.

II.

The Circuit Court of Appeals erred in holding that Arnold, who organized and operated the bankrupt as his agency or instrumentality, could, by advancing money to it and taking a deed of trust upon its property as security, secure for himself the right, prior to its *bona fide* creditors, to subject its assets to the repayment of those advances.

III.

The Circuit Court of Appeals, after correctly holding the original advances made by Arnold to be capital contributions, erred in holding those subsequently made to be valid loans.

IV.

The Circuit Court of Appeals erred in ignoring the fact finding of the Referee and the District Judge that bankrupt was a mere agency and instrumentality of Arnold and in holding that it had a valid separate entity which could not be disregarded.

V.

The Circuit Court of Appeals erred in refusing to hold that if bankrupt could be regarded as a separate entity, the deed of trust was invalid for want of proper corporate action to authorize its execution.

BRIEF OF ARGUMENT.

Summary of the Argument.

A. Bankrupt was inadequately capitalized, operated as a mere corporate pocket of, and dominated and controlled by, A. M. Arnold throughout its existence, to such an extent that its affairs were managed, not for the best interests of the corporation, viewed as a separate entity, but to serve Arnold's individual interests. It was, therefore, properly held by the Referee and the District Judge that the business of bankrupt was in truth Arnold's business, that he could not be its creditor, and that all advances made by him for the purpose of carrying on that business should, as opposed to claims of *bona fide* creditors, be properly construed as contributions to its capital.

B. If bankrupt should be regarded as a separate entity from Arnold, the deed of trust was invalid for want of proper corporate action authorizing its execution.

Argument.

A.

The decision of the Referee and of the District Judge in this case is based upon the familiar principle that in order to prevent wrong courts of equity will look through the form of corporate entity to the substance beneath. Application of this principle, in circumstances similar to those here involved, by at least five of the Circuit Courts of Appeals and numerous Federal District Courts, has resulted in every case in a holding that the sole stockholder of a corporation, organized and operated as a mere adjunct or instrumentality for carrying on all or a portion of the stockholder's personal business, is in truth the real owner of that business, and can not, therefore, also be its creditor.[4]

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[4] Some typical decisions are *In re Kentucky Wagon Mfg. Co.*, 6th Cir., 71 F. (2d) 802; *New York Trust Co.* v. *Island Oil & Transport Corp.*, 2nd Cir., 56 F. (2d) 580; *Clere Clothing Co.* v. *Union Trust & Savings Bank*, 9th Cir., 224 Fed. 363; *Centmont Corp.* v. *Marsch*, 1st Cir., 68 F. (2d) 460; *Forbush Co.* v. *Bartley*, 10th Cir., 78 F. (2d) 805; *Henry* v. *Dolley*, 10th Cir., 99 F. (2d) 94; *In re Charles K. Horton, Inc.* (D. C. Tex.), 22 Fed. Supp. 905; *In re Otsego Waxed Paper Co.* (D. C. Mich.), 14 Fed. Supp. 15; *In re Burntside Lodge, Inc.* (D. C. Minn.), 7 Fed. Supp. 785.

In *In re Kentucky Wagon Mfg. Co., supra*, the Bank of Kentucky, which had occupied exactly the same status toward Kentucky Wagon Manufacturing Company that Arnold did to the bankrupt here, was denied the right to prove its claim upon a mortgage executed to secure advances made by it to the Manufacturing Company. The Sixth Circuit Court of Appeals there said:

> "The determinative question is, not whether the New Company was in fact a legal entity or corporation, but whether the relationship of agent and principal existed as between it and the Bank; *i. e.*, whether the New Company was an instrumentality of, or an adjunct to, the Bank. * * * To allow the claim would be nothing short of permitting the Bank to prove its debts against itself and satisfy them out of its own assets to the exclusion of the rights of bona fide creditors. It is also apparent that the $2,000,000 mortgage was in

A similar application of the principal has been made by this Court in the recent cases of *Taylor* v. *Standard Gas & Electric Company,* 306 U. S. 307, and *Pepper* v. *Litton,* 308 U. S. 295. The latter of these contains an extensive review of the authorities, and cites with approval nearly every one of the decisions mentioned in the margin above. Petitioner submits that the reasoning and language of the *Pepper* case squarely support the ruling of the District Court here and are decisive of this case.

The record here shows a combination of nearly every one of the circumstances enumerated by this Honorable Court in the *Pepper* case as requiring the subordination of so-called loans or advances by a sole stockholder to the claims of other creditors. The evidence established, and the Referee found, "dominancy and exploitation" of the bankrupt by Arnold; that bankrupt was used "merely as a corporate pocket" of Arnold, "who, with disregard of the substance or form of corporate management, has treated its affairs

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substance nothing more than an attempt to secure to the Bank a lien upon its own property."

In the *Kentucky Wagon Manufacturing Company* case the court completely ignores the corporate fiction. In others of those cited above, the same result is reached by superimposing on that fiction another; that the advances made by the stockholder are not loans but contributions to the capital of the business. Such a case is *New York Trust Co.* v. *Island Oil & Transport Corp., supra,* where Circuit Court of Appeals for the Second Circuit said:

> "If a subsidiary is a mere instrumentality and its business is really that of the parent company, a loan by the parent to the subsidiary will be subordinated to the claims of creditors of the subsidiary. *Baker Motor Vehicle Co.* v. *Hunter,* 238 F. 894 (C. C. A. 2); *S. G. V. Co.* v. *S. G. V. Co.,* 64 P. 265; 170 A. 271. The reason is that the proprietor of a business cannot lend money to the enterprise and thus curtail the rights of creditors by sharing in *pari passu* with them, and such loan is regarded as a contribution to the capital of the business."

Whatever the method of approach, however, the decisions with substantial unanimity have arrived at the same result; that is, the postponement of the claim of the sole stockholder to that of bona fide creditors.

as his own''; that bankrupt was incorporated with a nominal capital wholly insufficient to enable it to operate and that ''the capital necessary for the scope and magnitude'' of its operations was furnished by Arnold under the guise of a loan.

The record further shows beyond question an attempt on the part of Arnold, which the decision of the Circuit Court of Appeals would, in part, crown with success, to, ''by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors''; to utilize ''his strategic position for his own preferment''; to do ''indirectly through the corporation what he could not do directly'', and, as the dominant influence over the bankrupt, to use ''his power not to deal fairly with the creditors of that company but to manipulate its affairs in such a manner'' that when its creditors came to collect their just debts ''the bulk of the assets had disappeared'' into Arnold. Indeed, on these facts, a harsher remedy than that applied by the District Court might have been invoked and Arnold might well have been held personally liable for the debts of bankrupt.[5]

The Circuit Court of Appeals, while agreeing with the Referee and District Judge that the advances made by Arnold shortly after incorporation should be treated as capital contributions and that they did not, therefore, constitute valid debts, based its decision solely on the inadequate capitalization. Even if the Circuit Court's view that this was the sole ground for striking down the claimed indebtedness were correct, its holding that advances necessitated by original inadequate capitalization should not be

[5] Cf. *Consolidated Rock Products Co.* v. *DuBois*, — U. S. —. In that case the plan of reorganization actually provided for the cancellation of such of the bonds of the subsidiaries as were held by the parent and, therefore, gave the creditors all the relief they are asking here, but this Court held it should have gone further and subjected the assets of the parent to the claims of the creditors of the subsidiaries.

treated as debts, but that those necessitated, in large part at least, by depletion of the capital through unauthorized withdrawals should be, is clearly unsound. Its effect is to permit the doing, by indirection, of what it holds cannot be done directly. If the Court very properly frowns on the launching of a corporation with inadequate capital it is impossible to comprehend why it should sanction the depletion, after launching, of the capital to a point where it is again inadequate.

An even more fundamental fault with the opinion of the Circuit Court, however, is that it wholly ignores the vital fact, found by the Referee and District Judge, and not disputed by respondent, that bankrupt was merely respondent's agency or instrumentality. It is not entirely clear from the opinion whether the Court took the view that this finding was not supported by the evidence or whether it was regarded as immaterial. Since the former would constitute an effort to overthrow concurrent fact findings by the Referee and District Judge when no attack had been made on them and would thus constitute a clear usurpation of the fact jurisdiction of the trial court, it must be assumed the Court of Appeals took the latter view and regarded the finding as immaterial. This interpretation of the opinion is strengthened by the fact that the court recognizes that its holding is not in harmony with the language used and decisions cited in *Pepper* v. *Litton,* and construes that opinion as not approving those decisions, saying:

> "While an extensive review of authorities was made in the Pepper case, with a classification of them as to the remedies applied, there was no specific approval of any, but only a decision of the case before the Court" (R. 288).

This one sentence from the opinion makes clear the fundamental point of difference between the District Court and

the Circuit Court of Appeals. The former has construed the opinion of this Court in the *Pepper* case as meaning what it says and has applied the principles there laid down to the facts in this case, which they unquestionably fit. The latter has attempted to limit the scope of this Court's opinion to the particular facts there involved, in disregard of the language, which is susceptible of no such limitation. It is submitted that the District Court was clearly right and the Court of Appeals clearly wrong.

While the Circuit Court has held, and petitioner agrees, that the validity of the claimed indebtedness is a question of bankruptcy law and, therefore, not one as to which the law of Texas will govern, it may not be inappropriate, since respondent has contended to the contrary, to point out that it is settled law in Texas that where one person owns and controls all the stock in a corporation, whenever, in the interest of justice it is necessary to do so, the courts will unhesitatingly look through the corporate shell to the substance of the sole stockholder behind,[6] and that the only Texas decision discussing the precise question here presented; that is, whether a sole dominating stockholder can

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[6] *Aransas Pass Harbor Co.* v. *Manning,* 94 Tex. 558; *Boston & Texas Corp.* v. *Guarantee Life Insurance Co.* (Tex. Civ. App., Err. den.), 233 S. W. 1022; *Williams* v. *Freeport Sulphur Co.* (Tex. Civ. App.), 40 S. W. (2d) 817; *Continental Supply Co.* v. *Forrest E. Gilmore Co.* (Tex. Civ. App.), 55 S. W. (2d) 622; *Lybrand* v. *Miller-Lybrand Co.,* (Tex. Civ. App.), 75 S. W. (2d) 286; *Bush* v. *Gaffney* (Tex. Civ. App.), 84 S. W. (2d) 759; *Irish* v. *Bahner* (Tex. Civ. App.), 109 S. W. (2d) 1023.

In *Aransas Pass Harbor Co.* v. *Manning,* the leading Texas decision, the Supreme Court says:

> "Other decisions tend to the conclusion that whilst in theory of law, the corporation and its stockholders are distinct persons, and the latter have no agency for the former, yet equity, which looks to the substance of things, may, in an appropriate case, and for the purposes of justice, treat a debtor corporation, and an individual owner of all its shares as identical."

be also a creditor of the controlled corporation, answers that question in the negative.[7]

Thus whether the matter be considered as governed by the Federal or the Texas decisions, the judgment of the District Court was right and that of the Circuit Court of Appeals wrong.

B.

Even if the Circuit Court of Appeals was correct in its conclusion that the advances made by Arnold to the bankrupt in 1937 and 1938 constituted valid loans, it does not follow, as that Court further held, that the deed of trust created a valid lien. Petitioner attacked the deed of trust on the alternative ground that even if bankrupt should be held to be a separate entity from Arnold and not simply his agency or instrumentality, the deed of trust was, nevertheless, void, or voidable, because not properly authorized by any qualified representatives of bankrupt (R. 13).

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[7] *United States & Mexican Trust Co.* v. *Delaware Construction Co.* (Tex. Civ. App.), 112 S. W. 447. (The South Western Reporter erroneously shows "Writ of Error granted" in this case. We are advised by the Clerk of the Supreme Court of Texas that no writ was ever applied for.) There, in a suit brought to foreclose a mortgage on the properties of Texas Southern Railroad Company, Delaware Construction Company, the sole stockholder of the Railroad Company, was denied the right to participate in the proceeds of foreclosure as holder of some of the bonds secured by the mortgage. The Court said:

> "But there is still another reason which we think is sufficient to deny a recovery of the intervenor in this case. While the shareholders are, in a sense, separate and distinct from the corporation, in many transactions equity will regard them, for practical purposes, as being the same. *Aransas Pass Harbor Co.* v. *Manning*, 94 Tex. 563. The construction company, as the owner of the railway company, did indirectly whatever was done by the latter. * * * To permit the construction company through its domination to burden the property of the railway company with incumbrances, a part of which it may hold, and then share to that extent with the bona fide purchasers of bonds, would be to give that company the right to incumber its own property with liens in its own favor."

The Referee and District Judge, since they struck down the indebtedness as a whole, did not find it necessary to pass on this alternative contention (R. 76). They did, however, find the facts material to it. These were that the trust deed was executed by Arnold without any meeting or resolution of the board of directors of the bankrupt to authorize it and that at the time of its execution, if the bankrupt should be considered an entity separate from Arnold, all three of its nominal directors were interested adversely to it in the transaction (R. 53). These facts, which fully support petitioner's contention, were wholly ignored by the Circuit Court of Appeals, as was, indeed, this entire branch of the case.

It is fundamental that a corporation may sell or mortgage its principal properties only by action of its board of directors. In Texas,[8] moreover, it is well settled that a board of directors may act for the corporation only in a regularly constituted meeting.[9]

Furthermore, it is the law of Texas that contracts between a corporation and one of its directors or officers wherein

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[8] It is clear that the law of Texas governs questions relating to the formal validity of corporate acts.

[9] *Austin City Railway Co.* v. *Swisher* (Tex. Ct. App.), 1 White & Willson Civil Cases, 33; *Nicholstone City Co.* v. *Smalley* (Tex. Civ. App.), 51 S. W. 527; *Wichita Falls Electric Co.* v. *Huey* (Tex. Civ. App.), 246 S. W. 692; *City of Floydada* v. *Gilliam* (Tex. Civ. App.), 111 S. W. (2d) 761.

In the Nicholstone case the court, in striking down a contract for erection of improvements which attempted to give a lien on the corporate property, said:

> "But superior to any such consideration is the proposition that neither the individual directors, nor a majority, however great, of stockholders, acting separately, could thus bind the corporation. Action, in itself binding on the corporation, could only be taken by them as a body at a regularly constituted meeting, for the reason that it is only thus that all interests are represented and heard."

the adversely interested director purports to act for the corporation are invalid.[10]

Since the deed of trust was executed by Arnold, as president of the bankrupt, to his daughter, as trustee for himself; since it was not authorized by any resolution of the board of directors of the bankrupt; and since, indeed, all the directors, if bankrupt be considered a separate entity from Arnold, were interested adversely, clearly the deed of trust did not constitute a valid corporate act.

It follows then that if the Court of Appeals was right in treating the bankrupt as a separate entity, it was necessarily wrong in upholding the deed of trust, which can be sustained as a corporate act only by disregarding the corporate entity and treating Arnold's acts as those of the bankrupt.[11] Such a view would, of course, make necessary the affirmance of the judgment of the District Court that Arnold could not be a creditor at all. To ignore this dilemma, as did the Circuit Court, may be an easy, but it could hardly be said to be a just, solution.

Conclusion.

It is respectfully submitted that this case calls for the exercise by this Court of its supervisory power. The deci-

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[10] *Tenison* v. *Patton*, 95 Tex. 284; *Texas Auto Company* v. *Arbetter* (Tex. Civ. App.), 1 S. W. (2d) 334. As said in the Arbetter case:

> "It is a wholesome and thoroughly settled rule that a director of a private corporation cannot vote, with propriety, in a matter affecting his private interest, any more than a judge can sit in his own case. He cannot, with propriety, deal in his own behalf in respect of the corporate property, or in respect of any matters involving the exercise of his duties as director. And, when he violates this rule of propriety, and enters into a contract with the corporation, especially a contract of purchase of corporate assets, and his vote as a member of the board is necessary to the passage of the resolution authorizing it, this action of the board is sometimes void, and in all cases voidable, at the instance of the corporation, or of its stockholders, or of its injured creditors."

[11] *Aransas Pass Harbor Co.* v. *Manning*, 94 Tex. 563.

sion of the Circuit Court of Appeals for the Fifth Circuit unsettles important questions decided by this Court in *Pepper v. Litton* and makes it essential to the orderly and uniform administration of estates in bankruptcy that certiorari be granted and that, upon submission, the judgment of the Circuit Court of Appeals be reversed and that of the District Court affirmed.

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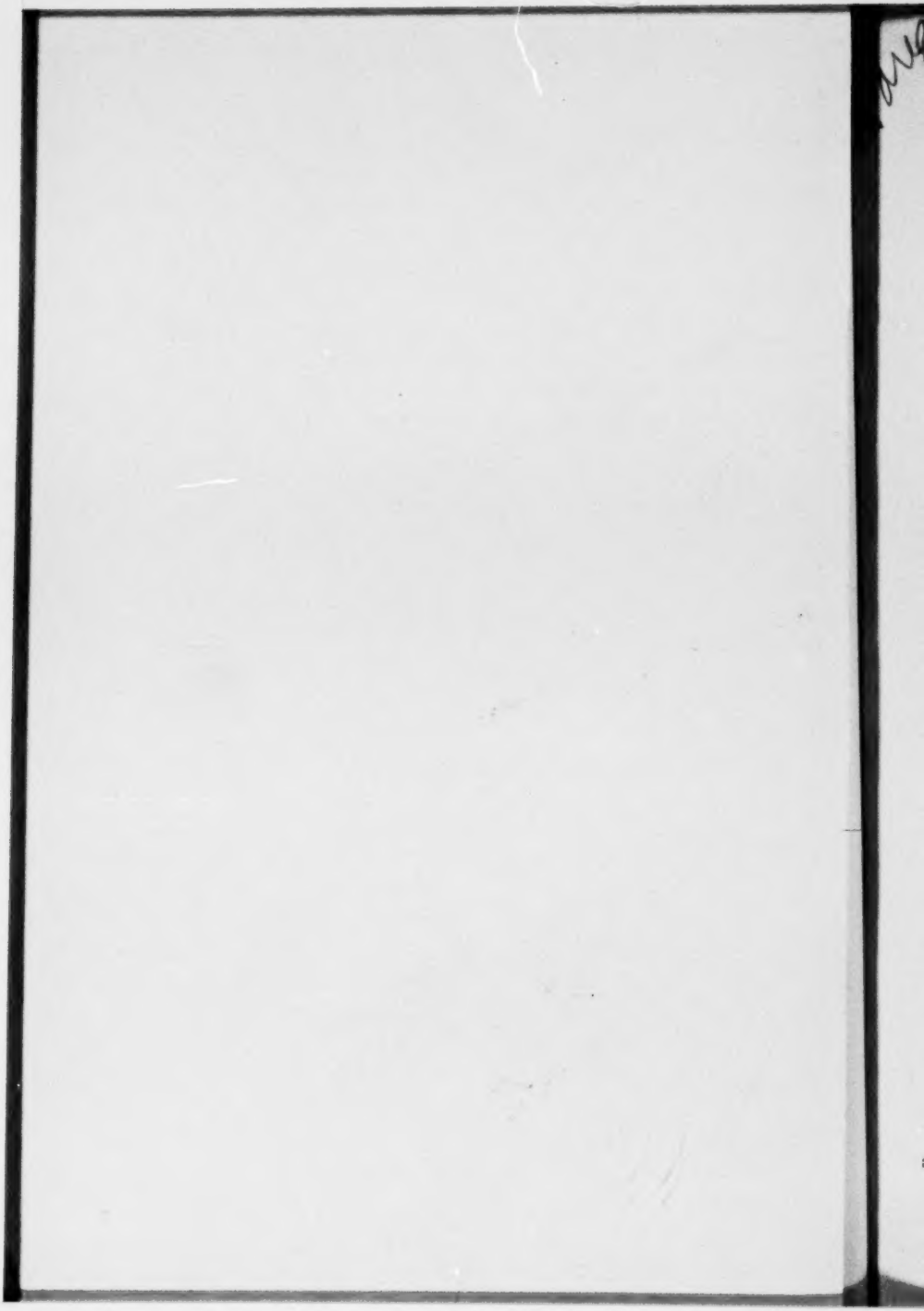
(3896)



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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1940

No. 985

H. A. PHILLIPS,
TRUSTEE OF THE SOUTHERN BREWING COMPANY,
BANKRUPT, *Petitioner*,
v.
A. M. ARNOLD, *Respondent*

REPLY OF RESPONDENT

to

Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit

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SUBJECT INDEX

STATEMENT OF THE CASE 1-6

REPLY TO PETITIONER'S ARGUMENT 7-17

ADDITIONAL REASON WHY PETITION LACKS MERIT 17-19

CONCLUSION 19

TABLE OF CASES

Aransas Pass Harbor Company v. Manning, 94 Tex. 558 19
Blades v. Schmidt, 110 S.W. (2d) 158 19
City of Fort Worth v. National Park Bank of New York, 261 Fed. 817 19
Coppard v. Glasscock, et al., 46 S.W. (2d) 298 19
Hall v. Crawford and Delphenis, 11 S.W. (2d) 804 19
Kaminsky v. Phinizy, 54 Fed. (2d) 16 18
McClean v. Bradley, 299 Fed. 379 11
Martin v. Jourdanton, 185 S.W. 583 3
Maryland Casualty Co. v. Willig, 10 S.W. (2d) 415 3
Noblitt v. Barker, 97 S.W. (2d) 1010 12
National Bond & Investment Company v. Jones, 78 Fed. (2d) 601 18
Pepper v. Litton, 308 U.S. 295 7, 8, 13
Perrow v. Scott, 175 Fed. 46 18
Perry v. Brown, 76 S.W. (2d) 230 3
Planters' Cotton Oil Company, Inc., v. Hopkins, 53 Fed. (2d) 825 13
Quarles v. Eaton Blewett Co., 249 S.W. 465 3
Quarles v. Hardin, 249 S.W. 459 3
Sayers v. Navillus Oil Company, 41 S.W. (2d) 506 12
Sikes v. Bank, 197 S.W. 227 3
Staacke v. Routledge, 241 S.W. 994 12
Taylor v. Standard Gas & Electric Company, 306 U.S. 307 7, 8, 13
Tenison v. Patton, 95 Texas 284 17
United States and Mexican Trust Company v. Delaware Construction Company, 112 S.W. 447 13
Wilkinson v. Walker, 294 Fed. 939 19
Wolfe v. State Investment Company, 95 S.W. (2d) 511 17
Zorn v. Brooks, et al., 83 S.W. (2d) 949 10, 17, 19

REVISED CIVIL STATUTES OF TEXAS (1925)

Article 6646 3

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MAY IT PLEASE THE COURT:

Respondent is unable to concur in petitioner's "Summary Statement of the Matter Involved" and "Statement of the Case" and respectfully presents the following

Statement of the Case

Petitioner sued respondent in the Bankruptcy Court praying for the cancellation of a deed of trust (mortgage) given

by the bankrupt corporation, Southern Brewing Company, four and one-half years prior to bankruptcy, to secure respondent, its controlling stockholder, for moneys loaned to the corporation during the years 1934 and 1935 and again in 1937 and 1938. He also sought cancellation of the trustee's deed given to respondent, Arnold, as the highest bidder at foreclosure of his deed of trust, which occurred over five months prior to bankruptcy and over a year after default took place. The deed of trust, dated September 5, 1934, covered certain premises occupied by the corporation and was duly filed for registration and recorded in accordance with the laws of the State of Texas (R. 147, 148; 207 to 213).

Petitioner's attack on the deed of trust was predicated on the theory that the corporation, while under the control of Arnold as its principal stockholder, could not give Arnold a valid deed of trust to secure the money loans made by him to the corporation. It was petitioner's contention that the bona fides of this transaction were immaterial; that the complete absence of any unfair or unconscionable dealing with the corporation was immaterial; that the fact that the transaction was conducted at arm's length in precisely the same manner as if the corporation had borrowed this money from a bank was immaterial; that the indisputable fact that the transaction was for the benefit of the corporation and its creditors was immaterial. Indeed, it was his position that the only thing that counted was that Arnold was the controlling stockholder of the corporation and that the transaction became void per se by reason thereof.

Respondent's control of the corporation as owner of all but two shares of its stock was readily admitted, it being his contention that this did not place him under any disability in conducting a good faith transaction with the corporation, particularly when such transaction inured to the great benefit of the corporation; that so long as it was fair and aboveboard in all respects, his position as controlling and

dominating stockholder would not serve to vitiate the transaction. He submitted the entire matter to the close scrutiny of the court with full confidence that unqualified good faith and fair dealing would be found to have existed throughout his dealings with the corporation and its creditors. He stood upon the undisputed showing that the corporation and its creditors received every cent of the money loaned by respondent to the corporation in this transaction and that the net result thereof was highly beneficial to the corporation and to its creditors (R. 52 and 54). As evidence of the openness of the transaction, respondent pointed to the registration of the deed of trust in accordance with the laws of Texas, this being the method prescribed for the giving of notice to all persons of such a transaction.[1] None of the debts existing at the time of bankruptcy were owing by the bankrupt corporation at the time this deed of trust was placed of record; accordingly, each of the bankrupt's creditors had notice of this deed of trust and of respondent's rights thereunder at the time credit was advanced to the bankrupt corporation (R. 54). As proof of utmost good faith toward and fair play with the creditors, respondent also pointed to his refusal to draw any salary after October 31, 1936, although he actively managed the business of the corporation until May, 1938 (Referee's Certificate R.

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[1]Article 6646 of the **Revised Civil Statutes of Texas, 1925**, provides: "The record of any grant, deed or instrument of writing authorized or required to be recorded, which shall have been duly proven or acknowledged for record and duly recorded in the proper county, shall be taken and held as notice to all persons of the existence of such grant, deed or instrument." The Texas Supreme Court has held (**Quarles v. Hardin,** 249 S.W. 459; **Quarles v. Eaton Blewett Co.,** 249 S.W. 465) that compliance with this statute 'took the place of and was tantamount to actual knowledge" of the existence of such instrument and that such registration "charges every one with notice of its execution and contents." All creditors, general and unsecured, as well as lien creditors come within the scope of this statute. **Perry v. Brown,** 76 S.W. (2d) 230; **Martin v. Jourdanton,** 185 S.W. 583; **Sikes v. Bank,** 197 S.W. 227; **Maryland Casualty Co. v. Willig,** 10 S.W. (2d) 415.

61 and 62); to his passing up of interest collections on the loans to the corporation (Referee's Certificate Article XVII R. 62); to his refusal to draw one cent of dividend from the corporation throughout its existence (Referee's Certificate Article XX R. 65).

Petitioner made no complaint under the Federal Fraudulent Transfer Act, Title 11, Section 107, U.S.C.A., nor did the evidence raise any question falling within the provisions of that Act. Unlike certain innuendoes now appearing in the petition for writ of certiorari, petitioner in his petition below did not allege any express or intended fraud (R. 11-15, inc.). The Referee in Bankruptcy, after careful inquiry into and painstaking scrutiny of all of the dealings between the corporation and respondent and the corporation's creditors, failed to find a single fraudulent act, or any evidence of mismanagement or manipulation (R. 45 to 69, inc.). The District Court found none and the Circuit Court found none. It is apropos to notice the words of the Circuit Court: "We find here no proof of mala fides, or that the money was not fully paid to and used by the corporation in an honest effort to carry on its business" (R. 289); and again: "There is nothing to show the enterprise was entered upon or prosecuted with a fraudulent purpose" (R. 286).

The Referee in Bankruptcy and the District Court, although finding no fraud, mismanagement or manipulation, set aside the deed of trust on the bald proposition urged by petitioner that the control of the corporation by Arnold, placed him under absolute disability to become its creditor under any circumstances, even though the result of the transaction was a distinct benefit to the corporation. The good faith of the transaction and the fairness with which it was conducted were entirely ignored, as was the beneficial result thereof to the corporation and its creditors. The Circuit Court, while fully recognizing the rule that where fraud or

unconscionable conduct results from the transaction between the dominant figure in a corporation and the corporation, such transaction will be voided, followed the rule prevailing in Texas as well as in the Federal jurisdictions, that the acts between such parties will not be condemned where scrutiny reveals good faith and fair dealing. Because approximately $50,000.00 of the indebtedness secured by the deed of trust represented the balance of sums loaned to the corporation within a year after its incorporation, the Circuit Court, in disallowing same, held that it would treat such loans as contributions to the capital and not as an indebtedness. The loans made during the years 1937 and 1938,—after the corporation had been operating for over four years, aggregating in principal $47,050.00, the court held valid in every respect and, as to this indebtedness, upheld the deed of trust (R. 288). The trustee's deed given after foreclosure, not recorded until after bankruptcy, was set aside (R. 289). This petition, therefore, involves only the validity of the loans made in 1937 and 1938.

Other salient facts, undisputed and incorporated in the findings of the Referee, apparently considered unimportant by petitioner, but which respondent submits as facts highly pertinent to a proper consideration of this petition, are:

1. The Southern Brewing Company was duly and regularly incorporated under the laws of the State of Texas on July 12, 1933, and existed as such on the date of bankruptcy (R. 50-51).

2. The brewery assumed larger proportions, as time went on, than had been originally planned. Extensive improvements were made to include a bottling shop in addition to the keg brewery (R. 51).

3. Cancelled checks supporting each of the loans made by respondent Arnold to the corporation were intro-

duced in evidence and the corporation received the full use of this money (R. 52; 55 and 56).

4. At the time of the filing of the deed of trust for registration in accordance with the laws of Texas, none of the debts owed by the bankrupt corporation on the date of bankruptcy were in existence (R. 54).

5. In July, 1936, the corporation paid respondent the sum of $20,000.00 and in August, 1936, the sum of $7,400.00. Both of these payments were applied against the deed of trust note. In 1936, the corporation had a splendid year and made a nice profit in its business and thus was enabled to make these payments (R. 55).

6. In the words of the Referee "A large part of the profits of 1935 and 1936 were put into additions to the plant" (R. 65).

7. In the first four months of 1938—several months after default had been made in the payment of the deed of trust note, respondent loaned the corporation $30,000.00 additional under the provisions of the deed of trust. Under the terms of the deed of trust respondent could have foreclosed on September 5, 1937, but he continued not only to bear with the corporation but loaned it $37,050.00 more thereafter, which are loans here involved. *This entire amount went to the benefit of the creditors, as Arnold drew no salary and was paid no interest after that time* (R. 65, 62, 55 and 56).

8. All three directors of the corporation, two besides Arnold, approved the action of the corporation in giving this deed of trust to secure the loans obtained from Arnold (R. 188-189; 149).

9. The corporation was capitalized for a very substantial amount, to-wit, $50,000.00 all of which was paid in cash (R. 50 and 51). The additional money needed within a few months after incorporation was due, in part, to the addition of a bottling shop, when originally it had been planned to operate only a keg brewery (R. 51).

Reply to Petitioner's Argument[1]

A.

Petitioner, in commenting upon the transactions between Arnold and the corporation, employs such words as "manipulation," "unfair dealing" and kindred harsh-sounding terms. There are no pleadings to support such charges—not one whit of evidence upon which to base them. A searching survey of the dealings between Arnold, the corporation and its creditors by the Referee in Bankruptcy failed to produce a single finding of unfairness, manipulation or overreaching. The District Court found none and the Circuit Court in a very comprehensive review of the facts affirmatively stated that no mala fides was present; that there was "nothing to show the enterprise was entered upon or prosecuted with a fraudulent purpose" (R. 286); that the money loaned to the corporation by Arnold was "used by the corporation in an honest effort to carry on its business" (R. 289). It thus seems clear that these charges and intimations, so foreign to the record, have sprung up in a desire to affix some application of the rule announced in the PEPPER v. LITTON case, 308 U.S. 295 to the instant case. Indeed the petition is bottomed primarily on an effort to analogize this case with the PEPPER case and the case of TAYLOR v. STANDARD GAS & ELECTRIC COMPANY, 306 U.S. 307. Such attempted alliance is insupportable, the factual bases in each being widely divergent. Only a casual comparison of the controlling facts in the instant case with those in the two cited cases reveal these basic dissimilarities:

The PEPPER case involved an effort on the part of a sole stockholder of a corporation to wrongfully divert its assets

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[1]The reply is divided into Sections A and B, to correspond with the segregation adopted by petitioner.

through a "planned and fraudulent scheme" pursuant to which he conjured up large and exorbitant salary claims, which appeared to be nothing more or less than bookkeeping entries. This scheme was carried forward through the employment of various furtive steps, each executed in a sinister and shockingly fraudulent manner. The proof not only showed the presence of glaring fraud from the time of the conception of the scheme to its conclusion, but an acquisition on the part of the sole stockholder, Litton, of the assets of the bankrupt (in the words of the court) "not for cash or other consideration of value to creditors but for bookkeeping entries representing at best merely Litton's appraisal of the worth of Litton's services over the years." The facts presented a strong situation for the application of the rule that a sole stockholder cannot deal with the corporation in a manner resulting in fraud of the rights of third persons. In the TAYLOR case this Court held that the claim of Standard Gas & Electric Company against its subsidiary should be allowed to participate in the reorganization plan of the subsidiary only in subordination to the preferred stock of the subsidiary. This holding was bottomed on the conclusive showing of gross mismanagement and faithless stewardship of the affairs of the subsidiary by Standard to the detriment of the public investors. The striking acts of mismanagement and general unconscionable conduct there present made it a proper case for this rule to be applied.

Not the remotest kinship do these two cases hold to the case at bar. In the instant case the transaction was open and aboveboard, attendant with unquestioned good faith every step of the way. In fact, it presents a striking antithesis to the factual situations in the PEPPER and TAYLOR cases. Not only was there absent any vestige of fraud or bad faith but the lending of the money by Arnold to the corporation in 1937 and 1938 presented a commendable effort to aid the corporation in meeting its debts and needs; it involved a loan of money the

full benefit of which the corporation and its creditors received. It was an arm's length transaction which not only inured to the benefit of the corporation and its every creditor but of which act every creditor existing at the time of bankruptcy had notice before extending credit to the corporation. The undisputed facts showed that the corporation had been in business for several years when these particular loans were made; that it had previously enjoyed some prosperity and made substantial additions to its plant in 1935 and 1936 (R. 65), but in 1937 and 1938 found itself in need of money (R. 55 and 56). Business conditions in the brewing industry became worse and sizeable amounts of bad accounts had to be charged off (R. 176, 177). The corporation's distributing agency was having difficulty in making collections and could not pay its account (R. 136, 137, 138). These loan transactions were every bit as open, as fair and as legitimate as if the corporation had gone to a bank and borrowed the same amount of money.[1] That the corporation had to have the money to continue its business is not denied; that the terms of the loan were very reasonable must be admitted; that the corporation received the full use and benefit of every penny of these loans and that the creditors profited thereby is proven by the undisputed facts. It follows conclusively that no basis exists for any complaint.

If the rule contended for by petitioner is to be adopted it would preclude every stockholder owning fifty-one per cent or more of the stock of the corporation from lending money to the corporation in time of need. This is true because it must be conceded that a stockholder owning fifty-one per

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[1] As said by the Circuit Court: "Had this corporation borrowed of a bank upon the security of the plant, the debt would no doubt be valid. What would render it invalid when Arnold furnished the money? * * * The money went to relieve the needs of the business exactly as it would have done if a bank had advanced it. No other creditor was prejudiced or misled."

cent of the stock of a corporation is just as much in position to control and dominate the corporation as is one owning ninety-eight per cent of the stock. Such a rule would work an extreme hardship on many corporations, especially smaller ones. Such corporations frequently cannot obtain loans from banks or other institutions and there is no one left to come to its rescue other than the man who is interested in the corporation. It is submitted that the test of validity is now and should remain to be—not the extent of the interest of the lender in the corporation—but the fairness and honesty of the transaction.

The primary reason why the Referee in Bankruptcy and the District Court on the one hand, and the Circuit Court on the other, reached different conclusions lies in the failure on the part of the former to give effect to the rule that a contract between a corporation and its controlling figure, or all of its officers or all of its directors, as the case may be, is not void per se but that it may be avoided for unfairness or fraud. This rule is well settled in Texas and in Federal jurisdictions. The outstanding decision in Texas on this point is ZORN V. BROOKS, ET AL., 83 S.W. (2d) 949, by the Commission of Appeals, opinion adopted by the Supreme Court of Texas, which was completely ignored by the Referee and the District Court but given full effect by the Circuit Court. The Brooks Supply Company, a corporation, managed and dominated by T. D. Brooks, conveyed certain properties to Brooks. The transfer was attacked by the Trustee in Bankruptcy and in passing thereon the Supreme Court of Texas said:

> "The authorities generally are in complete accord in declaring that a contract between a corporation and one or all of its officers and directors is not void per se, but that it may be avoided for unfairness or fraud. (Citing numerous cases.) This is the settled rule in Texas." (Citing numerous cases.)

Typical of the decisions of the Federal Courts on this question is the case of McCLEAN v. BRADLEY, 299 Fed. 379, certiorari denied, 266 U.S. 619, where it was held that directors are not prohibited from lending money to the corporation "when it is needed for its benefit, and the transaction is open and otherwise free from blame."[1]

It is plain—and this fact is not disputed by petitioner—that if Arnold had not made this loan to the corporation it would have been compelled to seek a loan through some money lending agency in an effort to honestly continue its business. Assuming that some financial agency would have felt interested in making the loan, the conclusion is inescapable that the corporation and its creditors would not have fared nearly so well under such an arrangement as they did under the loan made with Arnold. He bore with the corporation long after it had made default; in fact, continued to make additional loans in an effort to help it survive (R. 65, 62, 55 and 56). He collected no interest in 1937 and 1938 when business conditions were unfavorable (R. 62). He drew no salary during those years (R. 61 and 62). In 1936 when the business showed a splendid profit, a substantial amount was applied to this indebtedness in an effort to cut it down, but in 1937 and 1938 when the business of the corporation suffered from conditions beyond its control, Arnold not only continued to pump $47,050.00 additional money into the corporation to give it additional life, but he did so without even receiving interest on the loans theretofore made (R. 65, 62, 55 and 56). This is conclusive evidence of good faith

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[1] Numerous Federal decisions to the same effect exist. In fact, the rule appears to be uniform. Other Federal cases are **Twin-Lick Oil Company v. Marbury**, 91 U.S. 587; **Rinn v. Asbestos Manufacturing Company**, 101 Fed. (2d) 344, certiorari denied, 308 U.S. 555; **Des Moines Terminal Company v. Des Moines Union Railway Company**, 52 Fed. (2d) 616, certiorari denied, 285 U.S. 537 (holding that question of good faith is the test of validity of contracts between the individuals interested in a corporation and the corporation itself).

and fair dealing for had Arnold not been imbued with a keen desire to promote the welfare of the corporation and its creditors, he could have foreclosed his deed of trust in 1937 without having to feed an additional $47,050.00 into the corporation's treasury. In considering the fairness of Arnold's conduct towards creditors, it should be noted that not one cent of dividends did he draw from the corporation and except for the year 1936, when the corporation showed a large profit, Arnold's salary withdrawals were very nominal, with no salary being charged for the years 1937 and 1938. Of the salary previously charged, Arnold permitted the sum of $9,570.98 to remain in the treasury of the corporation and this amount the corporation still owed him at the time of bankruptcy (R. 63). In other words, for his labors as president and general manager of the corporation from the time of its organization in 1933 until he parted with his stock in 1938, Arnold received no dividends, only a partial payment of interest and of the small salary credited to his account on the books of the corporation, over $9,000.00 was never withdrawn.[1] That these salient facts favorably stand the test of fairness and good faith cannot be questioned.

In Texas one-man corporations are regarded as separate entities and their transactions are considered legal and valid.[2]

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[1] The reference made by petitioner to Arnold's alleged "withdrawals" of "more than $90,000.00" throughout the corporation's existence is incorrect (R. 62 and 63). The amounts actually paid Arnold consisted principally of approximately $50,000.00 payments on loans Arnold made the corporation in 1934 and 1935 (R. 61 to 65, inc.).

[2] Among the numerous Texas cases announcing this rule are **Noblitt v. Barker,** 97 S.W. (2d) 1010, writ of error refused by Supreme Court; **Sayers v. Navillus Oil Company,** 41 S.W. (2d) 506, writ of error refused by the Supreme Court; **Staacke v. Routledge** (Supreme Court), 241 S.W. 994.

The same rule has been followed by the Federal Courts, typical of which is PLANTERS' COTTON OIL COMPANY, INC. v. HOPKINS (Fifth Circuit), 53 Fed. (2d) 825, wherein the court said:

> "It is the general rule that the corporation and the stockholders are essentially distinct entities, and that though to circumvent fraud the corporate entity may be regarded as a fiction, ordinarily it must be regarded as having a real, a substantial, existence. (Citing cases.) Nor does the fact that one person owns all or substantially all of the stock of the corporation at all change the rule." (Citing cases.)

The foregoing review of the facts in this case and of the rules of law applicable thereto demonstrates the fallacy of the contention that the decision in this case conflicts with the decision of this Court in the TAYLOR and PEPPER cases. Equally as unfounded is the assertion that the decision in this case is in conflict with certain cases decided by the Circuit Court of Appeals and listed on top of page 5 of the petition. There is nothing in any of these cases inconsistent with the decision in this case. None of the transactions under inquiry in those cases involved an open, good-faith transaction under which the corporation and the creditors were benefited; in fact, the situation in each case was such as to require the disregard of the corporate entity in order to avoid fraud or injustice. The same is true of the Texas case (UNITED STATES AND MEXICAN TRUST COMPANY v. DELAWARE CONSTRUCTION COMPANY, 112 S.W. 447) referred to in the footnote on page 15 of petitioner's brief. In that case the stockholder was guilty of a clear wrong, in that he had become heavily indebted to the corporation and to prevent the occurrence

of an injustice occasioned by the stockholder's own wrong and dereliction a recovery was denied.[1]

Reference is made in petitioner's brief to the organization of Monte Carlo Distributing Corporation which acted as the distributing agency of the product manufactured by the bankrupt corporation. The reference leaves the impression that Arnold made some character of profit through this corporation. This is incorrect. Arnold did not draw, either directly or indirectly, one cent from the Monte Carlo Distributing Company. He did not even draw a salary from this company (Referee's findings, R. 64). This is but further evidence of the complete fairness he exercised toward the corporation and its creditors. The reason for the indebtedness of this subsidiary distributing company to the parent company was fully explained (R. 135 to 142) and the Referee made detailed findings of fact thereon (R. 64 and 65).[2]

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[1] The following excerpt shows the basis of the court's holding: "The principles of equity forbid that a shareholder by whose dereliction the assets of an insolvent corporation have been depleted could, as a creditor, share equally with other creditors in the distribution of those assets until he had made amends for his own wrong, or discharged his own obligation to that corporation."

[2] As to the Monte Carlo Distributing Company, the Referee found as follows:

> "The Monte Carlo Company at one time had as many as ten branches in various cities in Texas and had as many as 50 to 60 employees who were paid by it. The largest of these branches was at San Antonio and it was the only one in operation at the time of bankruptcy herein or for some time prior thereto. At the time of bankruptcy the San Antonio branch of Monte Carlo owned accounts receivable in the amount of approximately $10,000. There was evidence that the other branches also owned accounts but the amount was not established. Most of these other branches had been closed for more than a year prior to bankruptcy. Through the years of the existence of Monte Carlo, it had to charge off certain of its accounts as uncollectible, the amount so charged off not being shown in the evidence. Payments were made by it on the Southern

Petitioner's suggestion that the loans made in 1937 and 1938 should be called "contributions to capital" is extremely far-fetched. If Arnold's advances to the corporation in 1933 and 1934 are to be considered contributions to the capital as held by the Circuit Court, the corporation, in 1934, had a capital in excess of $125,000.00. It conducted its business with good profit in 1935 and 1936 and made substantial additions to its plant in those two years (R. 65). Its sound capital and financial structure prior to the making of these loans is demonstrated by the audit ending with the fiscal year date of October 31, 1936 (Exhibit C, R. 239-241) showing assets of $261,145.15, liabilities only $136,122.25. In the latter figure is included the unpaid balance of Arnold's 1933 and 1934 advances, which when considered as capital contributions in line with the Circuit Court's opinion, leaves the liabilities as only approximately $85,000.00—against assets worth $261,145.15. This audit was identified and fully explained by petitioner's witness, E. C. Smith (R. 109-111), who prepared it. In the light of these facts, it must be conceded by petitioner that the words of the Circuit Court, "They (1937 and 1938 loans) were truly loans and not new capital" present a correct conclusion.

B.

The second contention advanced by petitioner, that the

Brewery account right along, but these payments were always falling a little behind the charges.

"'Neither Arnold nor Otto drew any salary from the Monte Carlo Company. Otto, who was its secretary from May 20, 1935, to the date of bankruptcy, knew of no instance where the Monte Carlo Distributing Company diverted any of its assets other than to the payment of the Southern Brewing Company account as far as it could pay it. He also knew of no dividends ever paid by the Monte Carlo Company. The testimony also showed that it was the experience of breweries generally to have a substantial amount of uncollectible accounts occurring in their business despite reasonable efforts to avoid it.'" (R. 64 and 65.)

deed of trust is invalid because "not properly authorized by any qualified representative of the bankrupt" must fail. In the first place, petitioner's factual premise is erroneous; next, even if the facts were as stated by the petitioner, the instrument would still be valid under the Texas authorities.[1]

In his discussion petitioner proceeds as if Arnold had obtained this deed of trust without the knowledge or approval of the other two directors of the corporation. The undisputed testimony of both the witness Otto and Arnold is to the contrary. Arnold testified that at the meeting when this matter was discussed were present M. H. Otto, one of the directors, Mr. Arnold another of the directors and an attorney, W. D. Orem (R. 188-189). The witness Otto testified to exactly the same facts (R. 149; 167). The undisputed testimony further shows that subsequent to this meeting the matter was taken up with the third director, Mrs. Ida L. Arnold (R. 189). Even if there had been no formal meeting, its validity could not be challenged on that ground because the corporation received and accepted the full benefit of the transaction. After the execution of the deed of trust, which provided for future loans as well, the corporation received, accepted and used for its and the creditors' benefit the full fruits of this transaction. A plainer case of ratification and estoppel is hardly conceivable.

The fact that the controlling director, Arnold, was adversely interested to the corporation in this transaction does not, as petitioner contends, invalidate the instrument. All of the directors could have been adversely interested and it would still require a showing of unfairness or fraud before the instrument could be set aside. This is the settled rule in Texas as so clearly appears from the pronouncement of the

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[1] Petitioner concedes that this question is controlled by Texas law. In this respondent fully concurs.

Supreme Court of Texas in the case of ZORN v. BROOKS, supra, viz.:

> "The authorities generally are in complete accord in declaring that a contract between a corporation and one or all of its officers and directors is not void per se, but that it may be avoided for unfairness or fraud. (Citing numerous cases.) This is the settled rule in Texas." (Citing numerous cases.)

The case of TENISON v. PATTON, 95 Texas 284, cited by petitioner in support of his contention, not only fails to sustain petitioner but expressly holds that a corporation can deal with its officers and directors, and that even a sale by a director to the corporation is valid "if he makes a full disclosure of all facts known to him about the subject, takes no advantage of his position, deals honestly and openly, and concludes a contract fair and beneficial to the company."[1]

Additional Reason Why Petition Lacks Merit

As Trustee in Bankruptcy, petitioner may avoid any transfer or encumbrance by the bankrupt which any creditor might have avoided had bankruptcy not intervened. As a prerequisite to recovery, it is essential for the trustee to prove that he represents some creditor who could have avoided such transfer or encumbrance. Since all of the creditors represented by petitioner admittedly are "subsequent creditors"— cred-

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[1] The right of officers and directors to transact business with the corporation has been long recognized in Texas. One of the more recent cases, **Wolfe v. State Investment Company** (Civil Appeals), 95 S.W. (2d) 511, involved the execution of a deed of trust on the assets of the corporation to a stockholder to secure a loan. In upholding the transaction, the court said: "A corporation has the right to transact business with its directors and stockholders."

itors whose claims and rights arose subsequent to the execution and recordation of the deed of trust, none of such creditors could have attacked the deed of trust in question, had bankruptcy not intervened. Accordingly, the trustee is without standing to make this attack.

The undisputed evidence shows, and it was so found by the Referee (R. 54), that none of the debts owing at the time of bankruptcy were in existence at the time of the execution and recordation of the deed of trust.

The rule here invoked is well established by numerous Federal and Texas decisions. In KAMINSKY v. PHINIZY (Fifth Circuit), 54 Fed. (2d) 16, the Trustee in Bankruptcy sought to recover from Kaminsky moneys obtained from the corporation for a stock sale transaction to the corporation. The court held that "the transfer of the bankrupt's money was not subject to be avoided at the instance of the Trustee in Bankruptcy, unless it might have been avoided by a creditor of the bankrupt." * * * "If that transfer was voidable by anyone, when bankruptcy occurred, it was not avoidable by a creditor other than one who was a creditor when the transfer was made."

Similarly in PERROW v. SCOTT (Fourth Circuit), 275 Fed. 46, the trustee sought to set aside a deed of trust on the claim that it was fraudulent and void as to debts of the bona fide creditors of the bankrupt. In denying recovery the Circuit Court said:

> "Moreover, and this of itself would appear sufficient, the trustee's petition does not allege, and no attempt was made to show, that any of the parties in whose behalf this belated attack is made were creditors of the bankrupt at the time the deed of trust was executed and recorded. It is not for them to say that the security is fraudulent."

To the same effect are the following cases: NATIONAL BOND

& INVESTMENT COMPANY v. JONES (Sixth Circuit), 78 Fed. (2d) 601; CITY OF FORT WORTH v. NATIONAL PARK BANK OF NEW YORK (Fifth Circuit), 261 Fed. 817; WILKINSON v. WALKER, 294 Fed. 939.

This rule is well recognized in Texas. COPPARD v. GLASSCOCK, ET AL., 46 S.W. (2d) 298, by the Commission of Appeals of Texas, holding approved by the Supreme Court of Texas, wherein it was held that subsequent creditors could not attack a fictitious deed of trust; ARANSAS PASS HARBOR COMPANY v. MANNING (Supreme Court), 94 Tex. 558; ZORN v. BROOKS, 83 S.W. (2d) 949, by the Commission of Appeals, opinion adopted by the Supreme Court.[1]

Under the foregoing authorities, it is clear that it is incumbent on the trustee to plead and prove that he represented some creditor who could have avoided this transaction. There is neither pleading nor one scintilla of proof to show that the trustee represents a single creditor whose debt was in existence at the time the loans in question, or the last of them (R. 55 and 56) were made.

Conclusion

It is respectfully submitted that the petition for writ of certiorari not only fails to show any conflict in this decision and other decisions of this Honorable Court or any of the Circuit Courts, but fails to disclose any error in the determination made. That the decision is fully just to petitioner seems plain.

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[1] Other Texas cases reiterating this rule are **Blades v. Schmidt,** 110 S.W. (2d) 158 (Civ. App.); **Hall v. Crawford and Delphenis,** 11 S.W. (2d) 804 (Civ. App.).